NATIONAL FORECAST DESCRIPTION
The Forecast Period is the Third Quarter of 1999 to the Fourth Quarter of 2003

The U.S. economy continued to grow as it reached the end of the 2nd millenium. Already, it's the longest peacetime expansion, and in February 2000 it will be the longest expansion on record. Despite its long run, the economy shows few signs of slowing down. In fact, some signs show it is actually speeding up. After growing at a 1.9% annual rate in the second quarter of 1999, real GDP posted a 5.7% showing in the following quarter. Early estimates suggest it grew about 5.0% in the fourth quarter of last year. Overall, real GDP is believed to have grown 3.9% in 1999, well above almost every estimate of its potential. Another measure that has outperformed almost every expectation has been employment. Last year the U.S. civilian unemployment rate averaged 4.2%, which is about one and a half percentage points below a reasonable estimate of full employment. Given the tight labor market, one would expect to see inflationary pressures surfacing. However, inflation has been relatively tame. In fact, employee compensation growth actually slowed from 3.5% in 1998 to 3.1% in 1999. Energy prices did rise significantly in 1999, but this jump was from depressed levels. Even with the surge in energy prices, consumer inflation was just 2.2% last year. As it prepares to break the expansion record, the economy is more aptly described as hitting full stride versus being on its last leg.

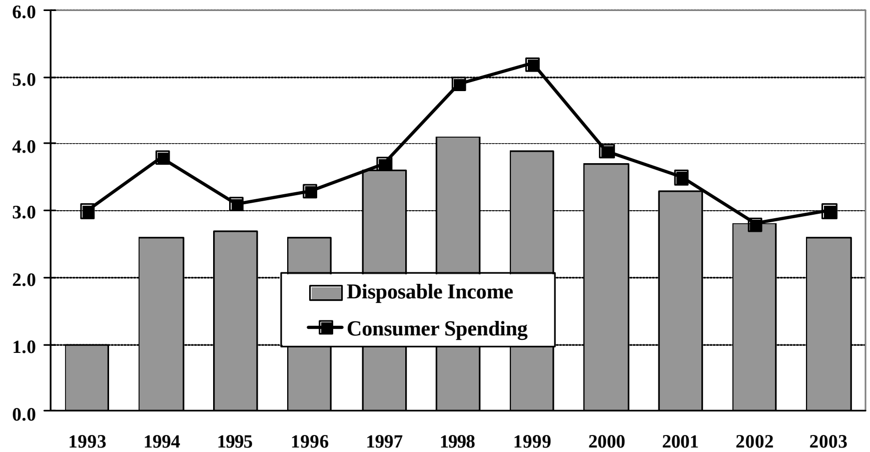
The economy's long string of successes has led to speculation that we have entered an era of "the New Economy." An important feature of this school of thought is that something fundamental has happened to the economy that has made it less volatile. In a way, it could be described as the economy that would not die. On closer inspection the "new economy" looks a lot like the "old economy." And to paraphrase Mark Twain, "the news of the business cycle's death is greatly exaggerated." What we are seeing is the "old economy" prospering under nearly ideal conditions. As such, it still remains vulnerable to disruptions. A classic example is a policy mistake by the nation's central bank. Although inflation is currently tame, it could heat up in the future. If the Federal Reserve were slow to react to this threat, prices could accelerate quickly. In order to wrangle inflation, the Federal Reserve would have to tighten more severely than if it had acted more promptly to the inflation threat. The higher interest rates would throw cold water on the hot economy and plunge it into a recession. The economy could also stumble if the stock market falters. Such a scenario could happen. A look at fundamentals suggests the stock market is overvalued by 30%, hardly a trivial amount. Furthermore, the rise in the stock market has buoyed consumer confidence. Should the stock market go south, so would consumer confidence and spending. This could start a chain reaction that would eventually lead the economy into a recession.

The current forecast assumes there will be no major policy mistakes nor will there be a catastrophic drop in the stock market. Thus, there should not be a recession over the forecast period. Instead, the forecast calls for the economy to cool. Interestingly, the slowdown will not come from weak demand, but weak supply. The booming economy has dried up the labor pool. Expanding businesses will find it increasingly difficult to find qualified employees. Eventually, the tight labor market will put pressure on inflation. However, the Federal Reserve is expected to maintain its vigilance and keep inflation in check while avoiding a recession.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Real consumer spending accounts for about two-thirds of the economic activity in the U.S., and it has fueled the strong economic growth in recent years. In fact, real consumer spending has out paced both real GDP and disposable income growth over the last four years. While spending can rise faster than income for short periods, at some point it should return to the rate of income growth. This is because consumers eventually exhaust savings and credit sources. American consumers appear to be reaching the point where it will be harder to maintain the current rate of spending above income growth. In order to support their spendthrift ways, consumers have turned to their savings and to credit. The U.S. personal savings rate dropped from nearly 9.0% in 1992 to about 2.0% last year. The main reason consumers have let personal savings slide is because they believe the rising stock market is doing their saving for them. The ratio of wealth to income has risen to nearly 6 — its highest level ever. Rising confidence and low interest rates have also convinced consumers to take on record levels of debt during this expansion. It was believed that consumers had exhausted their taste for debt when the ratio of non-mortgage consumer debt to disposable income was around 18% in 1994. Since then it has become obvious that consumers are comfortable with higher levels of debt. The ratio of debt to income was just over 20% in 1998 and showed no sign of easing in 1999. Another measure shows that for the first time total U.S. household debt (including mortgage debt) has risen above after-tax income. Again, increased household wealth seems to have played a role. It should be pointed out that not all households are shouldering an equal debt burden. Anecdotal evidence suggests much of the new debt has gone to the least creditworthy borrowers. This would help to explain the high number of bankruptcies in 1999. Several other factors suggest the brisk consumer spending in recent years will not continue. One of the reasons for the spending slowdown is the anticipated decline in consumer confidence caused by a cooling job market. In addition, rising interest rates will dampen the demand for big-ticket items. Also, the healthy stock market gains of the last few years are not expected to continue in the near future. The two big question marks are savings and debt. It remains to be seen whether consumers will lean even harder on these two financing sources over the forecast period. <u>The current forecast assumes real consumer spending growth will slow to nearly the same pace as real disposable income growth.</u>

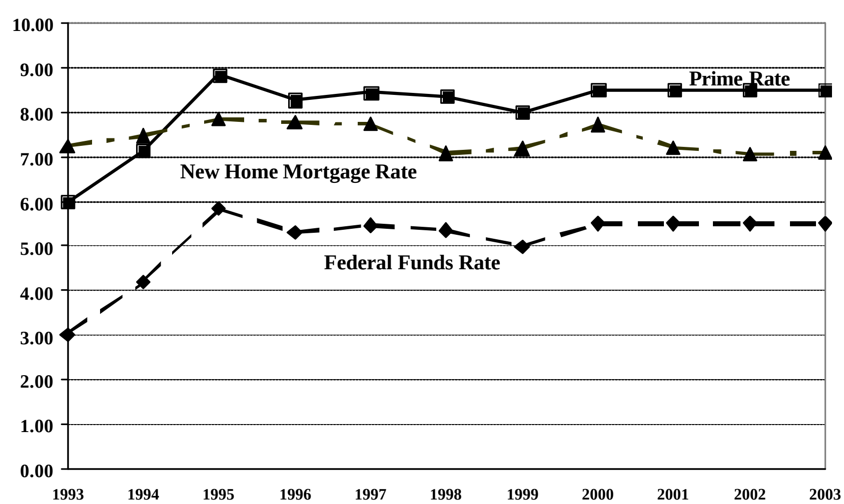
Real Spending & Real Income Growth



Source: Standard and Poor's DRI

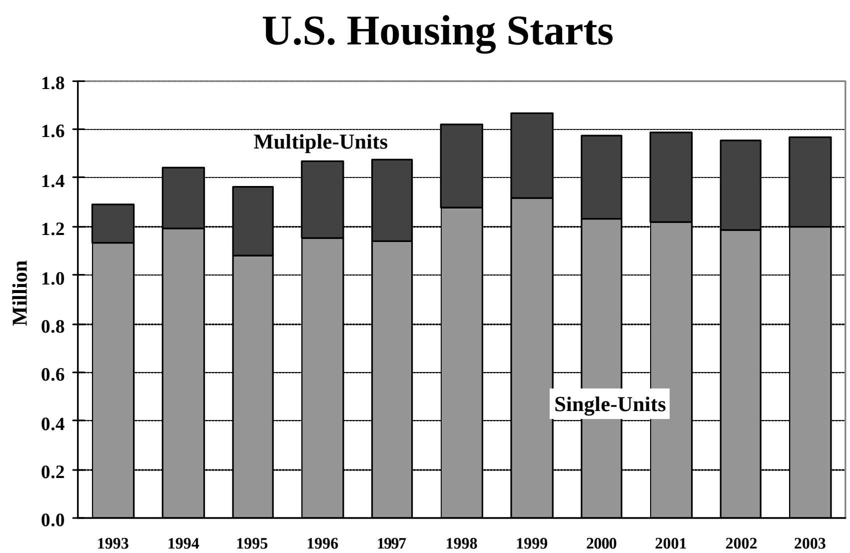
Financial: The Federal Reserve Bank raised its federal funds rate target by one-quarter percentage point to 5.5% and increased its discount rate to 5.0% in the fall of 1999. This brings the two rates back to levels seen prior to the 1998 Russian financial crises. This most recent rate hike will probably be the last of this tightening cycle. Several factors support this forecast. First, U.S. interest rates are well above those in other industrial countries. Second, although nominal interest rates are low,

Selected Interest Rates



Source: Standard and Poor's DRI

real interest rates are relatively high. This is because inflation is so low. Third, in order to preserve its nonpartisan image, the Federal Reserve usually does not like to make major monetary policy changes during an election year. Fourth, the nation's central bank may have shifted its emphasis away from inflation fighting and toward keeping the economy moving. In the statement announcing its recent tightening, the Federal Reserve noted that cost pressures appear generally contained, while there are tentative signs that growth may be slowing in certain interest-sensitive sectors of the economy. This should not be misconstrued to mean the Federal Reserve has abandoned its inflation-fighting vigilance. Chairman Greenspan and company have worked very hard to get the economy to perform in a nearly flawless manner. They will not hesitate to tighten if inflation threatens their hard wrought legacy.

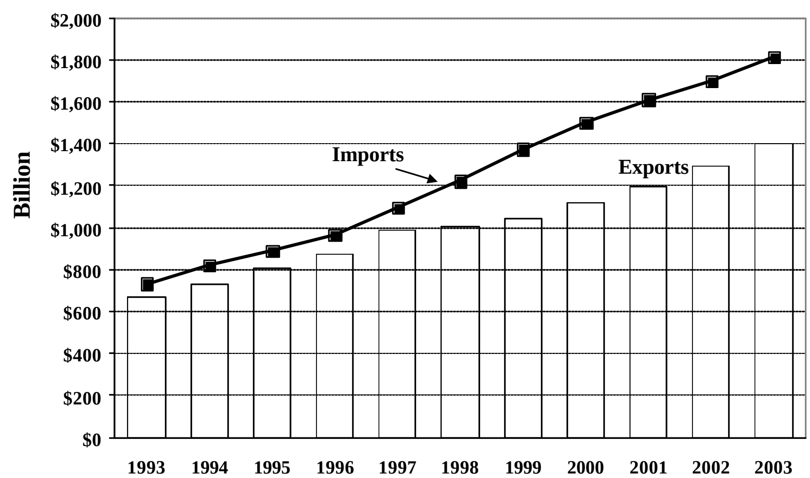


Source: Standard and Poor's DRI

Housing: The U.S. housing industry continued to grow last fall. This is not to say everything has gone smoothly for this industry in 1999. Indeed, there have been a few bumps in the road that generated fears that the housing industry's hot streak was finally cooling. For example, new home sales remained suspiciously high this summer despite rising interest rates. It was originally reported that sales of new homes were 930,000 units last August. However, this figure was later revised to 934,400. This was followed by another round of weak housing reports for September 1999. Sales of new homes dropped to 848,000 units in that month. Housing starts also declined, falling 2.8% that month. In addition, the supply of unsold new homes in September rose to 4.9 months supply from August's 4.0 months supply. Some of the slowdown is attributable to the hurricanes that battered the East Coast in the fall. However, economic fundamentals played a bigger role. It appears that rising housing prices and higher interest rates have finally affected new home sales. The average price of a new home rose from $192,400 in August to $196,900 in September. Mortgage interest rates rose by about 90 basis points last summer. Not all of the news was bad, however. Sales of new homes rebounded strongly to a record 986,000 annual pace in October 1999. The sales of existing homes topped 5 million for the 11th consecutive month in September. A couple of factors suggest the outlook for the housing sector remains relatively strong. First, the 30-year mortgage rate has fallen recently. Second, notwithstanding the recent increases in rates and home prices, housing is still quite affordable. The National Association of Realtors' Housing Affordability Index was 127.4 in the third quarter of last year. This means that half of the families in the United States had at least 127.4% of the income needed to buy a median-priced home. This affordability has translated into a larger portion of household owning homes. About two-third of U.S. households owned their homes in 1999, which was up from around 64% in 1990. <u>After rising to 1.67 million starts in 1999, there should be 1.57 million in 2000, 1.59 million in 2001, 1.56 million in 2002, and 1.57 million starts in 2003.</u>

International: International trade has been the most notable exception to the near perfect U.S. economy. The U.S trade deficit hit $24.9 billion annually in July 1999 and $23.5 billion in August 1999. To put this in perspective, the trade deficit for all of 1992 was just $27.8 billion. It is expected to rise to a whopping $263 billion for 1999. Trade was not always this much of a drag on the economy. The weakening U.S. dollar helped to boost exports after the mid-1980s. In fact, international trade eventually became an engine of economic growth. Unfortunately, the trade deficit ballooned after the early 1990s. Unlike the mid-1980s when the strong dollar hampered trade, the current deficit is a reflection of the U.S. economy's strength. The U.S. trade deficit was under $100 billion as recently as 1997. This changed in 1998, when the full effects of the Asian economic crisis were felt. In that year, the strong U.S. economy helped imports to grow at a 5.6% pace, while exports actually retreated 0.2%. As a result the trade deficit grew to nearly $150 billion in 1998. The lopsided trade situation continued in 1999, as exports rose by nearly 13.0% and imports eked out only 3.0% growth. This caused the trade deficit to deteriorate to $263 billion in 1999. The good news is that while the trade deficit is not likely to improve over the forecast period, it is not expected to get much worse. A review of worldwide economic conditions leads to this relatively optimistic outlook for trade. Europe should enjoy stable growth over the forecast period. Most of Asia is showing signs of recovery from that region's recent meltdown. However, Japan and Indonesia are notable exceptions. Depressed commodity prices have combined with imported financial shocks and domestic political problems to produce steep output drops in Venezuela, Colombia, and Ecuador. Depressed commodity prices and excessively tight monetary policy have played havoc with the Chilean economy. However, rising commodity prices point to an improved outlook for these countries.

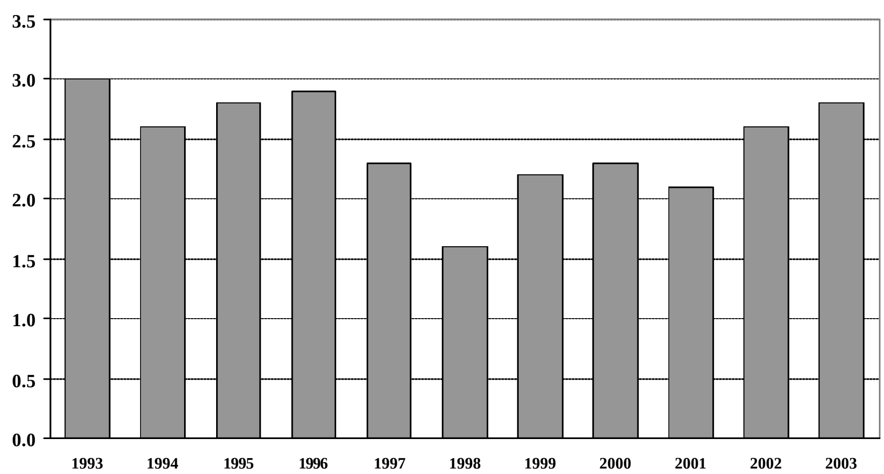
Real U.S. Imports and Exports



Source: Standard & Poor's DRI

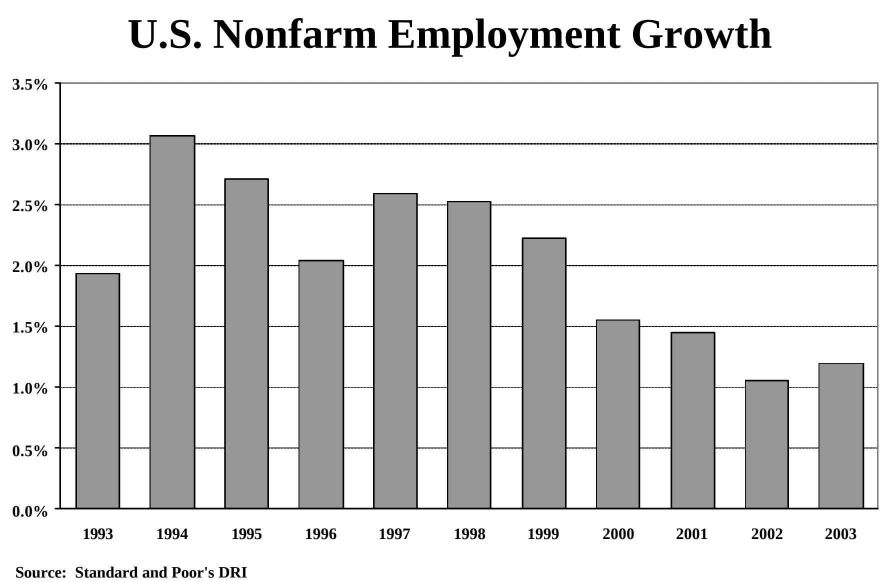
Inflation: The low inflation rate is an enigmatic, but welcome, feature of the current U.S. economy. During the second half of last year, inflation actually eased, as U.S. economic growth barreled along at a nearly 5.0% annual pace and the national unemployment rate approached record lows. Conventional wisdom suggests that inflation should be accelerating, not decelerating. Indeed, some consumer prices have risen. After falling in each quarter of 1998, the implicit price deflator for gasoline and oil soared through 1999, growing by as much as a 68% annual rate in that year's second quarter. Rising crude oil prices explain this increase. The acquisition price of foreign crude more than doubled from $10.83 per barrel in the fourth quarter of 1998 to an estimated $22.38 per barrel in 1999's last quarter. There are two major reasons for the price resurgence: the increased demand due to the

Consumer Price Inflation



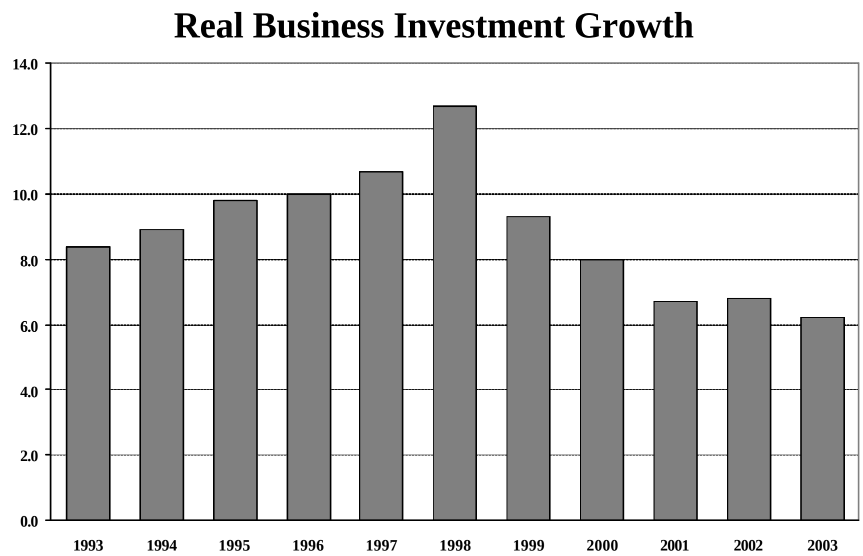
Source: Standard and Poor's DRI

Asian economic recovery and decreased supply caused by OPEC production cuts. The latter is a bit surprising because cartels are inherently unstable and higher prices usually lead to members cheating on quotas. All members, even the notoriously incompliant Venezuela, seem to be abiding with the current round of quotas. Late in the summer of 1999, Philip Morris announced an 18-cent increase in the price per pack of cigarettes. This raised the average per-package price of cigarettes 7.3% to $2.65. This change covers the January 1, 2000 increase in the federal excise tax and legal obligations. Additionally, commodity prices, with the notable exception of agricultural goods, have begun to strengthen. So far, inflationary pressures have only been noticeable at the producer level; consumers have yet to experience a significant jump in overall inflation. At this point of the expansion, inflation should be heating up with wages and other employee costs putting pressure on prices. However, these costs have been relatively tame. There are several explanations for this. First, employee benefits costs increases have been kept in check by the transition from traditional fee-for-service health plans to managed care health plans. Second, healthy productivity gains seem to keep unit labor costs down. Third, U.S. manufacturing capacity utilization has remained below inflationary levels. Fourth, global competition makes raising prices more difficult for domestic businesses. Given these conditions, inflation should remain relatively tame over the forecast horizon. Specifically, consumer price inflation should remain just under 3.0% per year and producer price inflation for final goods should rise by no more than 2.5% annually.



Employment: After a slow start, employment is currently one of the brightest facets of the near-record economic expansion. Employment is typically one of the last parts of the economy to show improvement during an expansion. During the current one, the economy took longer to achieve full employment than the duration of most recoveries. Historical records show that peacetime recoveries have lasted an average of 29 months. In March 1992, on the expansion's first birthday, the unemployment rate had actually jumped to 7.4%. It was 7.0% on its second birthday. Thus, with time seeming to run out, unemployment was still well above the full-employment level. It would take about four years after the recovery's start to reach full employment. A look at nonfarm employment data paints a similar picture. From 1991 to 1992, the number of nonfarm jobs in the U.S. grew a meager 0.3%. The pace improved to 1.9% in 1993. It rose again to 3.1% in 1994. Since then, nonfarm employment has grown by at least 2.0% annually. At first, the growing number of jobs available attracted more workers into the labor force, which kept the unemployment rate relatively high. Eventually, these workers found jobs and the unemployment rate began to move downward. In fact, it has moved to levels not seen in nearly three decades. In the fall of 1999, the U.S. civilian unemployment rate fell to 4.1%, which was well below the 5.4% estimate of full employment. Ironically, the tight labor market will be one of the factors limiting future job growth. This can be seen by looking at both nonfarm employment growth and unemployment. Over the forecast period nonfarm employment growth slows from 2.2% in 1999 to about 1.0% by 2003. However, the unemployment rate barely rises from 4.1% in 2000 to 4.4% in 2003, which is still a full percentage point lower than full employment.

Business Investment: Business investment has been one of the most consistent performers during the current expansion. A review of several numbers brings this point home. Real business fixed investment has grown much faster than real GDP in each year since 1992. Much of this growth was fueled by the double-digit rise in investment spending on computers and software. Economic reality made this level of investment necessary. American businesses invested heavily in technology in order to remain competitive with their global counterparts. In addition, the tightening labor market created a need to replace labor with capital. The increased investment may help to explain why productivity has soared in recent years. Like employment, productivity got off to a slow start during this expansion, but has picked up speed recently. Output per hour actually dipped slightly in 1993, but advanced by about 2.6% in both 1998 and 1999. It should be pointed out that investment alone does not account for this surge in productivity. Some of the increase in output reflects the fact that workers are more adept at using the new technology. In previous forecasts it was anticipated that companies would hedge against Y2K-related supply disruptions with higher on hand inventories. This should have a negative impact in the first part of next year. If supply disruptions are minor, businesses will curtail production and work down stockpiles. On the other hand, if there were major supply interruptions, output would suffer. It now appears that the inventory buildup in the latter part of 1999 was not as large as had been projected earlier. Thus, the impact on GDP in the first quarter of 2000 should be smaller.



Source: Standard and Poor's DRI